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## **Negative earnings**

### **Features**

#### **Employment Income**

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*Pete Miller considers employment losses and deductions and the rules in ITEPA 2003.*

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### **Key Points**

- Setting out the legislative structure of employment income and expenses.
- A look at the legislative formulae.
- How might negative earnings arise?
- How might employment losses be used?
- Is it time for HMRC to improve their guidance here?

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A few weeks ago, *Taxation* published my response to a reader's query, under the title *Hello and goodbye*, (see Readers' forum, 19 February 2009, page 179). Briefly, this asked whether tax relief would be due if the employee recipient of a 'golden hello' payment of £100,000 subsequently had to repay £50,000 because he left half way through the three-year period that he had contracted to work for. This raised the subject of what the position might be if such a payment exceeded earnings in the year of payment. The editor was sufficiently intrigued by the concept of employment losses to commission an article on the subject.

As I am fairly new to employment tax issues, and my training 20 years ago was under the old Schedule E rules, my starting point was to try and get a handle on the structure of the new(-ish) legislation in ITEPA 2003. In particular, I needed to understand the definitions of the different types of income chargeable under that Act, the deductions allowed against them and how they all interact. Nothing too difficult, then? Yeah, right!

## Income taxable

Our starting point is ITEPA 2003, Part 1 (and all statutory references in this article are to ITEPA, unless otherwise stated), which lays out the structure of the Act. Section 1(1) tells us that the Act charges income tax on employment income (Parts 2 to 7, see below), pension income (part 9) and social security income (part 10). We are only interested in employment income for the purposes of this article.

Part 2 then defines 'employment income', explains how the amount of employment income is calculated and lists the types of employment income dealt with by Parts 3 to 7 of the Act. The meat of the Act, in terms of explaining what income is taxable, is thus in Part 2.

Section 6 tells us that tax is charged on 'employment income', comprising 'general earnings' and 'specific employment income'.

Section 7 then explains each of these concepts. 'Employment income' means 'earnings', 'any amount treated as earnings' and 'any amount which counts as employment income'. 'General earnings' comprises earnings and amounts treated as earnings, and 'specific employment income' is amounts that count as employment income.

'Earnings' is defined in s 62 as salary, wages or fees, gratuities, other profits, and incidental benefits in money or money's worth; and any other emolument of the employment. 'Amounts treated as earnings' are defined in s 7(5) and, more helpfully, are set out in HMRC's *Employment Income Manual* at EIM00513.

Finally, 'amounts which count as employment income' are the types of income within Part 6 (income not earnings or share related) and Part 7 (broadly covering employment-related securities), as well as 'by virtue of ... any other enactment'.

Are you with me so far? I agree, it's hardly straightforward, is it? Perhaps **DIAGRAM 1** will help.

[Click here to view image](#)

## Taxable income of a year

In case you thought that the definitions of the various things that could be taxed were not sufficiently convoluted, the amounts that can be taxed in a given year are separately defined in Part 2, Ch 3.

For general earnings, s 9(3) says that the 'net taxable earnings' of an employment are charged to tax for the year. 'Net taxable earnings' are the 'taxable earnings' (TE) of the employment for the tax year, less the amounts allowed as deductions from that income (DE), as listed in s 327(3) to (5). This is in section 11, which refers to the calculation as TE -- DE. And, finally, 'taxable earnings' are covered in Part 2 Chapters 4 and 5, depending on whether the employee is UK resident (Chapter 4) or not (Chapter 5).

There is a similar structure for taxation of specific employment income. By s 9(5), the 'net taxable specific income' of an employment in a year is the taxable specific income (TSI) less the allowable deductions (DSI). In this case, the 'taxable specific income' comprises the amounts which count as employment income, as previously defined. And the deductions are those allowed by the Tax Acts except those under s 327(3) and (4).

The net taxable earnings and the net taxable specific income are to be computed separately for each employment for each year (sections 11(4) and 12(3)). The legislation also tells us that there is relief in the case of employment losses. We will return to this shortly.

Again, **DIAGRAM 2** might help to demonstrate these ideas.

[Click here to view image](#)

## Deductions

This, finally, brings us on to the allowable deductions -- the amounts that can be deducted from employment income in order to arrive at the net taxable earnings or net taxable specific income.

Most deductions are covered by ITEPA 2003, Part 5, which starts with a series of general rules. Section 327 introduces Part 5 and tells us that it provides for the deductions permitted from taxable earnings (TE in s 11) in calculating the net taxable earnings. So Part 5 covers the items referred to as DE in s 11.

Generally, deductions are allowed in respect of earnings from the relevant employment (and, one assumes, in respect of amounts treated as earnings, too) and not from any other employment (s 328) and the deductions cannot exceed the earnings from which they are deductible (s 329). We will come back to this later, but there are a number of exclusions from this general rule in s 329, including a number of provisions listed in s 332, expenses of a minister of religion and deductions not given under Part 5, such as capital allowances in CAA 2001, s 262.

As we have seen, deductions from amounts which count as employment income (TSI in s 12) are those allowed by the Taxes Acts except those listed in s 327(3) and (4). So deductions in ITEPA 2003, Part 5 cannot be part of DSI, and nor can capital allowances in CAA 2001, s 262 (which are also listed in s 327(4)).

As a general point, we would expect that deductions are different in character from earnings, amounts treated as earnings and specific employment income. Deductions would be allowed for actual (or deemed) spending required to be spent in order to earn the income. So they do not (or need not) spring directly from the actual or implied contract of employment.

## Employment losses

This is where it all starts to get interesting. Or should I say, even more interesting!

Section 11(3) reads as follows:

'Relief may be available under [ITA 2007, s 128] (setoff against general income):

(a) where TE is negative; or

(b) in certain exceptional cases where the amount calculated under subsection (1) is negative.'

The first thing we notice here (in s 11(3)(b)) is that a person's earnings before deductions can be negative. The second is that the relief available appears to be more restrictive when TE -- DE (i.e. the amount calculated under s 11(1)) is negative than when TE by itself is negative. Unfortunately, there is nothing in the legislation or the *Employment Income Manual* to explain what this further restriction (the 'certain exceptional

cases') is or why it exists.

Unlike s 11, s 12 does not recognise the possibility of negative TSI, as the nature of the deemed income specified cannot become negative. There is recognition that the sum of TSI -- DSI might be negative, but there is no provision to relieve any such losses as section 12(2) merely tells us that the net taxable specific income for that employment in that period is to be treated as nil. It is not clear why the negative sum cannot be relieved, although it is possible that provision for relief where DSI exceeds TSI is in the provisions relevant to the deductions themselves (which, readers will recall, are not within Part 5).

## Negative TE and the query

At first glance, the idea of negative TE is completely counterintuitive. One might immediately leap to the conclusion that the employee signed a very strange employment contract or that the employer was very canny with the small print. After all, most people would assume that the gross employment income should be positive; otherwise, you would be paying for the privilege of going to work! However, this is the issue that we identified as potentially being in point in the Readers' forum entry mentioned at the beginning of this article. So let's have a look at that point in more detail.

HMRC envisages that negative TE may arise 'where the loss arises directly from the conditions of the employment (for example, a departmental manager remunerated by a percentage of the profits of his or her department and responsible for a corresponding percentage of any losses, or a commercial traveller responsible for bad debts arising from orders obtained by him or her)'. They do not think that the payment of golden hellos was one of the situations envisaged by s 11(3). (This information came from an e-mail exchange with HMRC's Press Office, as the *Employment Income Manual* is silent about the whole of s 11.) Anne Redston also believes that there was once something in HMRC's manuals about employment income losses arising from reversed commissions, which also ties in with my response to the question.

Starting with the basics, positive TE will arise from the employment and will be the amount that it is agreed will be paid for the services provided. In general, we would assume that there is an actual employment contract but, if not, there is likely to be an implicit contract. So, for there to be negative TE, the loss must similarly arise from the employment contract itself, and not be in the nature of a deduction. Let's look at this in the examples mentioned above:

- If the terms of employment are that a manager is entitled to a percentage of profits, but is responsible for a percentage of losses, then that manager may have negative TE in a year in which the employer makes losses.
- If a salesman is responsible for his own bad debts, then he might have negative TE in a period when his sales are low and a number of previous clients default, so that the defaults exceed current year sales.
- Anne's example of insurance commissions came up in the case of *Gardner, Mountain and D'Ambrumenil v CIR* (1947) 29 TC 69. The terms of the commissions earned was that there was a claw-back of commissions paid if the client did not keep up the payments for three years, the claw-back being 1/36 of the commission for every month less than 36 that the premiums were not paid. The decision in the case was that commissions were earned, and therefore should be taxed, in the year that a policy was sold and that the claw-backs were relieved in the later year in which they arose. In effect, Anne's example would be the employment version of that case, so that negative TE might arise in a year when sales were low, but defaults on previously sold policies were high.

So what about the claw-back of the golden hello in the reader's query? As I said in my initial response, I believe that HMRC are right to contend that the £100,000 paid in Year 1 is taxable in full as earnings of that year. But I remain convinced that the claw-back should be relieved in the year in which it arises. It is clearly not a deductible expense of the employment, but it is equally clearly a cost that arises directly out of the contract of employment.

Indeed, I believe that the repayment must have the same character for tax purposes as the original payment. Thus the repayment of £50,000 is a component of TE for the employment in question in the period in which the employee became obliged to repay it. If he had received more than £50,000 earnings from that employment in the period, then he will still have positive TE, but it will be reduced by the £50,000 repaid. But if he was not paid at least £50,000 in that period, he would have negative TE from that particular employment in that period. (Remember, TE -- DE and TSI -- DSI are calculated separately for each employment in each year of assessment.)

Of course, there will also be practical aspects relating to the operation of PAYE. And we do not think that there is any provision for the repayment of National Insurance contributions for the period. But the principle stands, that a repayment of part of the golden hello should reduce TE of that employment for the period, possibly creating an employment loss.

## Negative TE -- DE

As we saw earlier, if TE -- DE is negative, relief is available under ITA 2007, s 128 only 'in certain exceptional cases' (ITEPA 2003, s 11(3)(b)). We have no idea what those exceptional cases are or why the use of TE -- DE employment losses are to be restricted in comparison to relief for employment losses arising from negative TE.

One possible explanation is that, since deductions generally cannot exceed earnings, the words 'certain exceptional cases' refer to the rarity of employment losses arising from DE exceeding TE, due to the general rule that deductions cannot exceed earnings (ITEPA 2003, s 329(1)). But this interpretation seems a bit of a stretch, especially as I would have thought that negative TE itself was even less common than negative TE -- DE.

As a final thought in this area, what if both TE and TE -- DE are negative? Do we have unrestricted use of the negative TE, but restricted relief for the deductions? Who knows?!

## Employee liability

As an aside, one of the allowable deductions is for liabilities related to the employment, under ITEPA 2003, s 348. This allows a deduction for liabilities arising to an employee because for actions or omissions in his capacity as an employee, as well as for liabilities imposed as a result of proceedings related to such acts or omissions.

Most of us would hope that our contract of employment grants us a wide indemnity for anything we do in the performance of our duties. So, if an act or omission of ours creates a liability, it is our employers who will be liable, not us. However, anyone who isn't certain might be advised to check his or her employment contract at once!

NB, on 12 January 2009, HMRC announced that they were legislating against 'an artificial and aggressive avoidance scheme that seeks to abuse tax reliefs available for employment-related liabilities incurred by employees and former employees' (see *Taxation*, 22 January 2009, page 54)

## Using employment losses

As we have seen, ss 11 and 12 require separate calculations of TE -- DE and TSI -- DSI for each employment in a year. What is not clear is whether they are to be aggregated for each employment. That is, suppose an employee has £30,000 net taxable earnings from his employment and £5,000 net taxable specific earnings, are they required to be aggregated to £35,000 employment income for the year?

This may look like a pointless question, but what if the net taxable earnings are negative for a period but there are net taxable specific earnings from the same employment? Then the question becomes relevant as the employee might want to use the employment losses against other income of the year, leaving the net taxable specific earnings intact. Obviously, if they have to be aggregated then this may not be possible.

There is no clear answer to this. Section 6 charges tax on employment income, being general earnings and specific employment income. And s 9 tells us that the amount of employment income charged for a year is the amount calculated under s 11 (TE -- DE) for general earnings and the amount calculated under s 12 (TSI -- DSI) for specific employment income, for each employment. But there is no clear rule as to whether the s 11 and s 12 amounts from a given employment are to be aggregated for any given year or dealt with separately.

What does seem to be clear is that each employment within a period is dealt with separately. Sections 9, 11 and 12 clearly refer separately to each employment and s 328 only allows deductions against the earnings of that employment. So if one employment generates a loss, the taxpayer is able to choose which income to set the loss against.

What can be done with an employment loss? The main relief is under ITA 2007, s 128 ('employment loss relief against general income'). Section 128 allows a person employed or holding an office in a year and having an employment loss for that year to set the loss off against general income of the loss-making year, the previous year, or both. So this would allow the loss to be set against income from other employments or offices (or even against net taxable specific income of the same employment or office), or against incidental income or investment income.

There is a further relief available if the employee or office holder does not have sufficient income to absorb all the losses. ITA 2007, s 130 permits unused employment losses to be set against capital gains as an allowable loss, on a claim and subject to the provisions of TCGA 1992, ss 261B and 261C. However, ITA 2007, s 130 refers to a claim by a person who 'cannot deduct all of a loss in an employment or office under a claim for employment loss relief'. This implies that relief from capital gains is only permissible if there is an excess of employment losses over general income for the loss-making year and the previous year. It does not appear that the taxpayer is entitled to shelter capital gains before income. Under current tax rates, it is also unlikely that anyone would want to.

## Conclusions

In many ways, the rewritten tax legislation is simpler to read, understand and operate. But there seem to be a plethora of similar terms with different definitions that are often confusing. In this article we have seen 'employment income', 'specific employment income', 'net taxable specific income', etc. I hope that this article and the diagrams have helped explain these to people who, like me, are relatively new to the field of employment taxes.

It is also a pity that HMRC's manuals do not cover some of these areas. There are literally dozens of pages on the meaning of 'earnings', but nothing at all on the calculations in ss 11 and 12 or on employment losses. That said, we know that HMRC staff are aware of the shortcomings of their manuals and other published information. Now that the tax law rewrite project is almost complete, I look forward to the start of the tax guidance rewrite project!